



Issue Date
November 27, 1995

Audit Case Number
96-PH-212-1002

TO: Sidney, B. Severe, Director, Office of Housing,
Pennsylvania State Office, 3AH

FROM: Edward F. Momorella, District Inspector General for
Audit, Mid-Atlantic, 3AGA

SUBJECT: Pine Hill Farms Apartments
Multifamily Project Operations
York, Pennsylvania

We audited the multifamily operations of Pine Hill Farms Apartments (Project). The purpose of our audit was to determine if York Associates (Owner) operated the project in accordance with the terms of the Regulatory Agreement and other applicable HUD requirements.

We determined that the Owner did not comply with Regulatory Agreement provisions pertaining to cash distributions and tenant security deposits.

Within 60 days, please give us, for each recommendation made in the report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us with copies of any correspondence or directives issued because of the audit.

Should your staff have any questions, please have them contact J. Phillip Griffin, Assistant District Inspector General for Audit, at (215) 656-3401.

Executive Summary

Pine Hill Farms Apartments was not operated in accordance with the terms of the Regulatory Agreement and other applicable HUD requirements. Ineligible distributions were made from the operating funds and the tenant security deposit account was underfunded.

Ineligible costs were paid from project operating funds

Ineligible distributions of \$274,196 were withdrawn by the Owner from the operating funds of the project. The General Partner told us that he did not know that distributions could not exceed surplus cash. As a result, funds needed to pay the project's normal operating costs were not available.

Security deposit account was underfunded

Contrary to the Regulatory Agreement, the security deposit account was underfunded by \$17,608. This occurred because all security deposit receipts were not deposited. As a result, security deposit reimbursements were paid from the project's operating account.

Recommendations

We made recommendations to recover the ineligible costs cited in the report and to improve operations at the project.

Auditee Comments

We discussed the draft findings with the General Partner at an exit conference on October 2, 1995. The General Partner submitted comments on the draft findings in which he agreed that prior management had misappropriated security deposits but current management should not be blamed for the actions of prior management. His response to the draft findings was considered and incorporated, where appropriate, in preparing the final report. A copy of the General Partner's comments is included as Appendix A.

Table of Contents

Management Memorandum	i
-----------------------	---

Executive Summary	iii
-------------------	-----

Introduction	1
--------------	---

Findings

1	Project Owner Improperly Withdrew Project Funds	3
---	---	---

2	Agent Cannot Account For All Tenant Security Deposits	7
---	---	---

Internal Controls	9
-------------------	---

Follow Up On Prior Audits	11
---------------------------	----

Appendices

A	Auditee Comments	13
---	------------------	----

B	Schedule of Ineligible Costs	15
---	------------------------------	----

C	Distribution	17
---	--------------	----

Introduction

Pine Hill Farms Apartments (project number 034-35028) is a 120 unit multifamily housing project located at 406 Piedmont Circle, York, Pennsylvania. The project is operated in accordance with a Regulatory Agreement, between HUD and the Owner, dated February 29, 1984. The mortgage was endorsed by HUD for insurance under Section 221 (d)(4) of the National Housing Act on March 1, 1974.

The project is owned by the partnership of York Associates, a New York limited partnership. The original General Partners were Larry Nick, William Weissel, Tom Kaye, and Arnold Bruck. Tom Kaye and Arnold Bruck no longer have a management interest in the project and William Weissel died in July, 1994. Accordingly, Larry Nick is the remaining General Partner.

The project was managed by William Weissel of Cameo Management until his death in July, 1994. On August 1, 1994, Diner Development replaced Cameo Management and managed the property until March 31, 1995. Effective April 1, 1995, Jordan Harris Management became the management agent.

The accounting records for the project are maintained at the Management Agent's office at Five Bayberry Close, Rye Brook, New York 10573.

Audit Objectives

We reviewed the operations of Pine Hill Farms Apartments to determine whether the Owner operated the project in accordance with the terms of the Regulatory Agreement and other applicable HUD requirements. Specifically, we determined whether Pine Hill Farms:

- had costs which represent valid project expenses;
- collected and reported all project income and;
- maintained a security deposit balance which equaled or exceeded the liability for tenant's security deposits.

Audit Scope and Methodology

We reviewed and analyzed pertinent project records maintained by HUD and the Owner. Those records included the Regulatory Agreement, bank statements, supporting documentation for expenditures, and other management and financial records. We evaluated internal controls to the extent they related to the audit objectives. In addition, we interviewed the Agent, the Owner, HUD program staff, and the Independent Public Accountant and performed a physical inspection of the project.

Our audit was conducted from January, 1995 through June, 1995 and covered the period January 1, 1991 through December 31, 1994.

We conducted the audit in accordance with generally accepted government auditing standards.

Project Owner Improperly Withdrew Project Funds

The Owner withdrew \$274,196 in ineligible distributions from project operating funds. The General Partner stated he did not know that distributions could not exceed surplus cash. As a result, funds needed to pay the project's normal operating costs were not available.

Criteria

According to the Regulatory Agreement,

- Owners shall not make distributions of assets or income of any kind except from surplus cash [Paragraph 6.(e)].
- Convey, transfer, or encumber any of the mortgaged property, or permit the conveyance, transfer or encumbrance of such property [Paragraph 6.(a)].

Appendix G, item II.F. of HUD Handbook 4350.1 REV-1, Multifamily Asset Management and Project Servicing, states that notes evidencing secondary financing must provide that any payments from project income are made only from surplus cash.

Paragraph 4-11 of HUD Handbook 4350.1 REV-1 states HUD strongly recommends that Owners target a minimum amount to be held in the Reserve Fund for Replacements account. The purpose of having a minimum amount is to have funds available for an emergency or unforeseen contingency.

Ineligible distributions from project funds

Improper cash distributions made from the Pine Hill Farms operating accounts are as follows:

<u>Year</u>	<u>Owner</u>	<u>Second Mortgage</u>	<u>Prior Year Surplus Cash</u>	<u>Excess</u>
1991	\$61,500	\$36,000	\$17,804	\$79,696
1992	30,500	36,960	0	67,460
1993	21,000	47,520	0	68,520
1994	11,000	47,520	0	<u>58,520</u>
				<u>\$274,196</u>

No surplus cash since 1992

The project has not been in a surplus cash position since 1992. When a project is in this situation, available funds are to be

used only for normal operating expenses unless specifically authorized by HUD. Therefore, the Owner cannot take cash distributions. Similarly, the second mortgage payments, as provided in the HUD Handbook and the amended sales agreement dated February 9, 1994, were only to be made from surplus cash. Therefore, disbursements for the HUD approved second mortgage were also ineligible because they exceeded the surplus cash available.

Funds not repaid as requested

The Owner disregarded HUD requirements. During 1994, HUD requested the General Partner to establish a payment plan to repay unauthorized distributions from previous years. The Owner disregarded this request and has not repaid the money. The General Partner told us that he was not aware that distributions could not exceed the prior year surplus cash.

Project placed at risk

The Owner has placed the project at financial risk and endangered HUD's investment as a result of the ineligible distributions. Within the past year, the project has not had sufficient funds to meet its operating costs. This has led to a lien being placed against the project.

Normal operating expenses not paid

Pine Hill Farms did not always pay the sewer and refuse bill during 1994 resulting in an outstanding balance of \$61,208. The municipality currently has a lien on the property totalling \$4,695. According to a City official, steps will be taken to increase the lien for the outstanding balance if the account remains unpaid. Accordingly, HUD's financial interest in the project is at risk. The Regulatory Agreement prohibits the Owner from allowing the property to be encumbered.

Mortgage payment made from Reserve account

The November, 1994, mortgage payment plus late charges totalling \$23,647 was made from the Reserve Fund for Replacements account. Correspondence from HUD to the General Partner, dated December 9, 1994, noted that HUD was extremely concerned about the financial condition of the project due to the release of funds from the account.

Reserve account below recommended amount

Our review of the Reserve Fund for Replacements account balance disclosed that the required amount has been deposited to the account on a regular basis. However, correspondence from HUD to the General Partner, dated December 9, 1994, noted that the Reserve Fund for Replacements account was below the recommended minimum threshold.

Based on the HUD guidelines, the balance of the Reserve Fund for Replacements account should be \$144,000. However, the account balance as of June 15,1995 was only \$46,621.

The project would have had sufficient funds to meet these operating costs if the Owner had not made ineligible distributions.

Auditee Comments

The General Partner stated he was willing to address the issues brought forth in the audit. However, he said that the property and/or partnership are not able to repay the funds as discussed in the audit.

Additionally, the General Partner stated:

"...It is inconceivable that now, after eleven years of continuous and open activity, that the partnership should be called to task for these payments; especially in light of the stellar track record of the new team. A review of the audits should make it clear to your office that all funds are properly accounted for, the property did not suffer as a result of these payments, and, if calculated, these payments would have constituted surplus cash...."

OIG Evaluation of Auditee Comments

The Regulatory Agreement requires that distributions of assets or income shall not be made except from surplus cash. Distributions exceeded surplus cash. Therefore, the distributions are ineligible and the Owner must repay the money regardless of the property's physical or financial condition.

Recommendations

We recommend that you require the Owner to:

1A. Reimburse the project \$274,196 for ineligible distributions during 1991 through 1994. The monies should be distributed as follows:

- Pay the outstanding sewer and refuse bill;
- Remit \$23,647 to the Reserve Fund for Replacements account to cover the November, 1994, withdrawal for the mortgage payment;
- Increase the Reserve Fund for Replacements account to the minimum threshold amount (\$144,000); and
- Place any remaining monies in the project operating account.

Agent Cannot Account For All Tenant Security Deposits

Contrary to the Regulatory Agreement, the security deposit account was underfunded by \$17,608. This occurred because all security deposit receipts were not deposited. As a result, security deposit reimbursements were paid from the operating account.

Criteria

Paragraph 6.(g) of the Regulatory Agreement requires the Owner to deposit and maintain security deposits in a trust account separate and apart from all other project funds. Further, the balance of this trust account must at all times equal or exceed the aggregate of all outstanding obligations under the account.

Security deposit account underfunded

Our review of the security deposit account for the period January, 1994, through December, 1994, disclosed shortages in the account. The security deposit balance ranged from \$173 to \$1,262 and averaged \$474 for the period. The security deposit balance of \$1,262 should have at least equaled the tenant security deposit liability of \$18,870, but it did not.

As of December 31, 1994, the project's security deposit account was underfunded by \$17,608. According to the prior Agent, all security deposits were deposited into a separate account. We found no evidence to support this statement.

Security deposits reimbursed from project operating funds

The prior two Agents reimbursed outgoing tenants for their security deposits from the project operating account. This practice could have been prevented had the security deposit account been fully funded.

Reimbursing tenants from the project operating account decreased available cash; thus, risking the tenant security deposits and the Project's ability to meet future operating costs.

Auditee Comments

The General Partner said that in a short time period they will have a fully funded security deposit account. In the meantime, they are once again funding a segregated security deposit account.

OIG Evaluation of
Auditee Comments

The General Partner's actions address our draft recommendations. However, the implementing actions are uncompleted. Therefore, we are repeating the recommendation in the draft report.

Recommendations

We recommend that you require the Owner to:

- 2A. Fully fund the security deposit account for Pine Hill Farms.
- 2B. Maintain the security deposit account in accordance with HUD requirements.

Internal Controls

In planning and performing our audit, we considered internal control systems of the management of Pine Hill Farms Apartments to determine our auditing procedures and not to provide assurance on internal controls. Internal control is the process by which an entity obtains reasonable assurance as to achievement of specified objectives. Internal control consists of interrelated components, including integrity, ethical values, competence, and the control environment which includes establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring.

Control Categories

We determined that the following internal control categories were relevant to our audit objectives:

Rental Collections
Disbursements
Owner Distributions
Project Maintenance and Condition
Tenant Security Deposits

Scope of Work

We evaluated all of the relevant control categories identified above by determining the risk exposure and assessing control design and implementation.

Significant Weaknesses

A significant weakness exists if internal control does not give reasonable assurance that the entity's goals and objectives are met; that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports. Based on our review, we believe the following items are significant weaknesses:

- (1) Owner Distributions (Finding 1)
- (2) Tenant Security Deposits (Finding 2)

This is the first OIG audit of Pine Hill Farms Apartments. The most recent Independent Accountant report, for the fiscal year ended December 31, 1993 was issued on November 7, 1994. There were no findings in the report.

Auditee Comments

Schedule of Ineligible Costs

<u>Recommendation Number</u>	<u>Ineligible 1/</u>
1A	\$274,196
2A	<u>17,608</u>
	<u>\$291,804</u>

1/ Ineligible amounts are not allowed by law, contract, HUD or local agency policies or regulations.

Distribution

Secretary's Representative, Mid-Atlantic, 3AS
Director, Internal Control and Audit Resolution, 3AFI
Director, Office of Housing, 3AH
Director, Field Accounting Division, 3AFF
Assistant Secretary for Field Management, SC (Room 7106)
Eleanor Clark, Comptroller/Audit Liaison Officer (Room 5132) (3)
Acquisitions Librarian, Library, AS (Room 8141)
Director, Participation & Compliance Division, HSLP (Room 6274)
Director, Division of Housing Finance Analysis, TEF (Room 8212)
Chief Financial Officer, F (Room 10166) (2)
General Counsel, C (Room 10214) (2)
Deputy Chief Financial Officer for Operations, F (Room 10166) (2)
Assistant Director in Charge, US GAO, 820 1st St. NE Union
Plaza, Bldg. 2, Suite 150, Washington, DC 20002
Attn: Mr. Cliff Fowler (2)

